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The Honorable William Proxmire
Chairman
Subcommittee on National Security Economics
Joint Economic Committee
Congress of the United States
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are responses to questions submitted by your Subcommittee for the record with your letter of 10 August. They pertain to China's economic development and recent reforms as discussed in a classified briefing on 3 August.

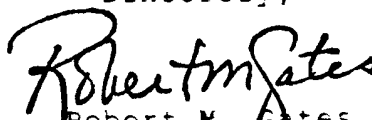
The enclosed material is unclassified.

In a separate channel, the Agency is forwarding a response to one of the Subcommittee questions which had to be classified
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I trust that the Agency information will assist the Joint Economic Committee in its review of leading economic issues.

Sincerely,


Robert M. Gates

Acting Director of Central Intelligence

Enclosure

SUBJECT: Letter to the Honorable William Proxmire
regarding responses to questions about China

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Responses To Questions Regarding Resource Allocation in China

Submitted by Senator William Proxmire, Chairman,

Subcommittee on National Security Economics of the US Congress

The farm sector has been reorganized and much of it turned over to private control. There has also been some decentralization of industry. How much of the economic growth in 1986 and 1987 can be ascribed to the private sector? How much to the reforms in general?

For the past 8 years Beijing has implemented economic reforms that have decentralized decisionmaking authority and increased the use of material incentives in the economy. These reforms have caused output in many sectors of China's economy to increase rapidly.

Reforms in the countryside have been extensive. Peasants now lease land for up to 30 years, make most production decisions on their own, and market all output remaining after they have fulfilled production contracts with the state. Beijing has encouraged peasants to diversify agricultural production and also has permitted them to leave farming and start up rural industries and service trades. However, the government continues to control the supply of important inputs such as fertilizer and diesel fuel and to set the price of grains purchased through state contracts.

Reforms in industry have been less extensive, but factory managers now retain a larger share of revenues and have more flexibility in determining production beyond that

which must be supplied to meet quotas in the state plan. Although the entrepreneurial, or private, sector of the urban economy has grown rapidly in the past several years, the number of self-employed workers in cities still amounts to less than 4 percent of the urban labor force. Therefore, the urban private sector has not had a large impact on economic growth in the past two years. Much of China's economic growth in the past two years can be attributed to the overall economic reform program.

You mentioned Beijing's concern over budget deficits. First, how large will the deficit be in 1987? Second, we never hear about budget deficits as a problem in other centrally planned economies. Why is it considered a problem for China?

According to Beijing's draft budget for 1987, the government deficit will grow by about 13 percent this year to 8.02 billion yuan (\$2.16 billion). However, Beijing's accounting format adds 6 billion yuan (\$1.6 billion) in domestic government bond sales and 14.6 billion yuan (\$3.9 billion) in anticipated foreign borrowing to the "revenue" side of the ledger. The projected government deficit would thus be substantially larger if calculated according to Western accounting methodology.

In the past, China has covered a substantial portion of budget deficits with overdrafts from its central bank. Beijing is concerned, therefore, that deficits will add to demand pressures and drive up prices on those goods that are produced outside of the plan.

In general, how reliable and complete are Chinese official economic statistics compared to those of the Soviet Union?

Chinese data, on the whole, are not as statistically reliable as that released by industrialized and newly industrializing countries. China faces many of the same problems that other countries at its level of economic development face in collecting accurate data and scientifically estimating economic indicators. Beijing realizes that it is vitally important to have accurate data when formulating economic policies, particularly as it increasingly relies on monetary and fiscal policies, in place of administrative dictates, to maintain economic stability. China, therefore, has stepped up efforts to improve the accuracy of its economic statistics.

In general, official statistics for the quantity of industrial output of particular industries in China and the Soviet Union are probably more reliable than statistics for the total value of production. We do not judge the comparative reliability of overall economic indicators for China and the Soviet Union.

What are your estimates for inflation and unemployment for 1987 and how does this compare with the recent past?

We do not publish a price index for China nor do we estimate China's unemployment rate.

Many foreign observers believe that the actual rate of inflation is higher than Chinese official statistics indicate. Year-to-year changes in the officially calculated inflation rate, however, may provide an accurate qualitative indicator of inflation trends. Listed below are inflation rates for the past several years that are calculated on the basis of China's official retail price index.

1979	2.0%
1980	6.0%
1981	2.4%
1982	1.9%
1983	1.5%
1984	2.8%
1985	8.8%
1986	6.0%

Rapid, reform-driven economic growth and policies allowing workers to open their own transport and service-oriented businesses have caused China's unemployment rate to fall since the late 1970s. However, Chinese officials admit that in many state enterprises more than one-fifth of the factory work force is surplus. China's rural sector also suffers from extensive underemployment of labor. Therefore, China's official unemployment statistics probably do not accurately depict the economy's ability to create productive employment opportunities for Chinese workers.

You discuss efforts to improve productivity, but no figures are cited. What are the figures for labor and capital productivity for each of the past 10 years?

Official Chinese statistics indicate that labor productivity in state-owned industrial enterprises grew at the following rates from 1979 to 1986.

1979	6%
1980	2%
1981	-2%
1982	2%
1983	8%
1984	8%
1985	8%
1986	4%

China publishes a time series that shows the gross output value of state-owned industrial enterprises per 100 yuan of fixed assets. The capital productivity numbers are seriously biased, however, because the fixed assets are valued according to their original purchase price.

The July 27, 1987, issue of Beijing Review contains a midyear report on the economy by the State Statistical Bureau. It shows 10 percent growth in GNP for the first half and a 15 percent rise in total industrial value. How reliable is this report and do you agree with it?

China has been publishing GNP estimates for only 2 years, and we have not yet made a judgment on the accuracy of these estimates. China measures the industrial output of large state-owned enterprises in constant prices, but it may not adequately adjust for inflation in measuring the output of small-scale rural enterprises--thereby biasing the industrial output estimate upward somewhat. Nevertheless, it is apparent

that overall economic growth, and industrial output in particular, picked up in the first half of 1987.

According to the Beijing Review midyear report, management reforms had been carried out in 37.8 percent of small, state-owned industrial enterprises by June 1987, as against 8 percent by year-end. Do you agree with this figure, and what does it say about the reforms?

We cannot independently confirm the estimates for the number of small, state-owned industrial enterprises that have carried out management reforms. In the past few years, Beijing has gradually extended the scope of management reforms. Chinese leaders have stated that industrial reforms will be carried out over a long period of time.

Explain the methodology for estimating China's GNP and the reasons for revising it downward since 1986. Nongovernment groups, such as the World Bank and Wharton Econometric Forecasting Associates, use a different approach for estimating the size of China's economy and come up with much larger estimates. Explain the differences between the CIA's and these other methodologies. Is the CIA considering whether to modify its methodology along the lines of the World Bank's?

Our estimate of \$343 billion for 1985 Chinese GNP was based on a time series that uses a 1983 exchange rate to convert Chinese currency values to US dollars. Beijing has devalued its currency significantly since 1983. The estimate for 1986 Chinese GNP that we gave during the hearing was based on the current exchange rate, and therefore does not represent a decrease in Chinese GNP.

There probably are several valid alternative approaches to calculating China's GNP from its officially released statistics.

What has constrained Chinese oil exports and what is the status of on-shore and off-shore exploration?

China reduced the volume of its oil exports by about 5 percent last year in response to lower world oil prices (oil export earnings fell by almost 50 percent), and Beijing publicly supports OPEC efforts to stabilize oil markets and prices. Over the next few years, growing domestic demand probably will restrain Chinese oil exports to near their recent levels.

Some foreign oil firms are continuing to explore for offshore oil, but the results to date probably have been disappointing for both Beijing and the foreign firms. China is continuing to exploit existing onshore fields and is stepping up efforts to explore for oil in the northwest region of China.

You say in your prepared statement that defense spending grew by 5 percent in 1986 but will grow by only 1.3 percent in 1987. Are those real or nominal growth rates, and, if the latter, what are the real rates and what have they been for the past five years?

Chinese budget statistics indicate that defense spending increased by 5 percent in nominal terms in 1986 and is budgeted to increase by 1.3 percent in nominal terms in 1987. The following lists the nominal growth rates for announced Chinese defense spending during the past few years.

1982	5%
1983	4%
1984	2%
1985	6%

We do not calculate a price deflator for Chinese defense expenditures, but it is highly likely that because of inflation in the past several years, announced defense expenditures fell in real terms.

I thought they were trying to hold down their defense spending. Why did it rise by 5 percent in 1986?

The 5-percent increase was slightly more than planned. That growth rate for defense spending was consistent with rates since 1982, which ranged from 2 percent to 6 percent.

What is the Chinese defense burden in terms of the share of GNP spent for defense, and to what extent does their relatively modest burden account for their good economic performance in recent years?

We estimate that China spends approximately 5 percent of its GNP on defense. By apparently restraining the growth of defense expenditures, Beijing probably has somewhat facilitated reform-driven economic growth.

We have numerous exceptions for China in COCOM. Does this suggest that we want China to buy U.S. weapons and military technology?

This question concerning US policy should be addressed to the Department of State and other US Government agencies. As for China's policy, Beijing is interested in acquiring selected Western military technology, including US technology that the United States exports to many countries. China probably is reluctant to become too dependent on any one source, however, and thus seeks to diversify suppliers, and where possible, to acquire manufacturing capability as well.

The Soviets are reportedly directly involved in several dozen industrial projects in China. Can you summarize the projects and their significance and provide for the record a detailed explanation of each?

In the two years since Chinese and Soviet officials signed a broad five-year agreement on technical cooperation, they have agreed that the Soviets will provide equipment and technical advice for the renovation of 17 Chinese factories and for the construction of seven new facilities. Neither side has published a list of the projects.

and we believe they may not yet have reached agreement on all of them. Bilateral discussions have focused on metallurgy, power generation and transmission, coal, machinery, railways, textiles, light industry, and chemical processing. Projects that have been mentioned in the Soviet or Chinese press as candidates for cooperation include:

<u>Project</u>	<u>Province</u>
-- Anshan Iron and Steel Corporation	Liaoning
-- Wuhan Iron and Steel Plant	Hubei
-- Baotou Iron and Steel Plant	Inner Mongolia
-- Fushun Aluminum Plant	Inner Mongolia
-- Matou Ore-Dressing and Coal Mining Plant	Hebei
-- Yiminhe Open-Pit Coal Mine and Coal-Concentrating Mill	Inner Mongolia
-- Xingangtai Coal Mine	Heilongjiang
-- Qixing Coal-Dressing Factory	Heilongjiang
-- Luoyang Copper Processing Plant	Henan
-- Luoyang No. 1 Tractor Factory	Henan
-- Xian Electrical Manufacturing Corporation	Shaanxi
-- Xian Insulation Plant	Shaanxi
-- Xian High-Voltage Circuit Breaker Plant	Shaanxi
-- Xian High-Voltage Insulator Plant	Shaanxi
-- Taiyuan Chemical Fertilizer Plant	Shanxi
-- Lanzhou Chemical Industry Corporation	Gansu
-- Nancha Timber Hydrolysis Plant	Heilongjiang
-- Jiamusi Paper Mill	Heilongjiang
-- Harbin Flax Mill	Heilongjiang

--	Thermal Power Plants	Shanghai, Shanxi, Shandong, Heilong-jiang, and Others
--	Power Transmission Lines	Shanxi-Hubei and Jilin-Heilongjiang
--	Rail Electrification	Unknown

China's ability to pay for Soviet technical assistance through barter trade, rather than hard currency, is one of the factors encouraging the development of technical cooperation with the Soviets. Beijing is seeking Soviet technology in areas--such as thermal power, open pit mining, hydroelectric generation, and long-distance electric transmission--where it is on a par with that available from the West. Beijing is also interested in Soviet assistance in modernizing Soviet-designed heavy industry facilities, where it has had difficulty attracting Western investment.

In contrast to the situation in the 1950s, when the Soviet Bloc was China's primary source of technical assistance and equipment, the number of Sino-Soviet technical cooperation projects planned for the 1986-90 period are dwarfed by the thousands of contracts for Western assistance that will be signed during the same timeframe. Sino-Soviet technical cooperation also will involve a comparatively small number of technical personnel; several hundred Soviet technicians will work on the Chinese projects between 1986 and 1990, compared to the tens of thousands of Western technicians that have worked with the Chinese over the past eight years.

What is the status and significance of the Soviet-Chinese Amur River project?

Soviet General Secretary Gorbachev called for the joint development of boundary river resources in his speech in Vladivostok in July 1986, and in October 1986 the Soviet and Chinese governments agreed to establish a committee to plan for joint development of the water resources of the Argun and Amur Rivers. Since then, the two sides have concluded a joint survey of the Amur River and signed a protocol stipulating that each side by 15 September 1987 should draw up a detailed report on constructing first-phase projects. These reports will provide the basis for a joint report to be written when Soviet experts visit China this October. Beijing and Moscow reportedly intend to work together in building a multipurpose dam and large hydropower stations to (1) prevent floods by regulating water levels of the two rivers, (2) reduce energy shortages in adjoining areas, and (3) harness water resources for agricultural purposes.

China and the Soviet Union originally considered jointly developing their boundary river resources during the 1950s, but the plan fell victim to the Sino-Soviet split. The present Soviet-Chinese Amur River project, taken together with heightened prospects for an eventual border agreement, signals willingness by both countries to defuse the once-contentious border dispute. The Chinese, however, still insist that political normalization is possible only if Moscow makes concessions on the "three obstacles" of Soviet support for Vietnam's occupation of Cambodia, the Soviet invasion of Afghanistan, and the Soviet military build-up along China's northern border.

What significance do you place on the revival of Chinese-Soviet trade and economic relations?

During the 1950s, Sino-Soviet trade equaled about \$1.2 billion annually, and accounted on average for almost 45 percent of China's total trade in any given year. Because of frictions between Beijing and Moscow that surfaced in the 1960s, the total value of Sino-Soviet trade in that decade was less than one-half what it was in the 1950s. In the 1970s, Sino-Soviet trade equaled about \$300 million per year, accounting on average for 2.5 percent of China's total trade.

The increase in political, economic, and scientific contacts between Beijing and Moscow in the past two years has been accompanied by an increase in Sino-Soviet trade. In 1985, bilateral trade increased by 45 percent to reach \$1.9 billion. Sino-Soviet trade grew by an additional one-third last year to \$2.6 billion. However, trade with the Soviet Union accounted for less than 4 percent of China's total trade in 1986, and probably will average about \$3 billion annually until 1990 under the terms of the current Sino-Soviet trade accord.

Is our military sales policy to China in conflict with our interests in Taiwan?

This question regarding US policy should be addressed to the Department of State and the Department of Defense.

What is the future of U.S. grain sales to China, and of U.S.-China trade in general?

In the early 1980s, sales of grain to China accounted for 30 to 40 percent of total US exports to China. Because of the success of economic reforms in the countryside, China's demand for grain imports has decreased considerably, and US grain sales to China were equivalent to less than 1 percent of total US exports to China in 1986. Although China has stepped up purchases of US grain in the first half of 1987, grain sales probably will continue to be a relatively small portion of total US exports to China.

Trade between China and the United States has grown at an average annual rate of almost 9 percent since 1980. If Beijing continues to implement market-oriented economic reforms, China's economy probably will continue to expand rapidly--as will its demand for capital equipment and industrial inputs. Because of the technological sophistication and high quality of US equipment, the United States will likely be able to expand its exports of those products to China. Growth of Chinese imports will partly depend on Beijing's ability to earn foreign exchange through exports, and Beijing probably will push hard for increased sales of handicrafts, textiles, and light industrial goods of low to moderate technological sophistication.

To what extent do Chinese textile exports, directly or through Hong Kong, threaten U.S. textile interests?

Tables A and B indicate that in 1986 China was the fourth largest exporter of clothing to the United States and the second largest exporter of textile fabrics and yarns. Table C shows that the share of US imports of clothing accounted for by China

has increased from 4 percent in 1980 to about 10 percent in 1986. Many categories of Chinese clothing and textile exports to the United States are controlled by quotas

The Department of Commerce and other US Government agencies can address the impact of these Chinese exports on the US textile industry.

Table A. US Imports of Clothing in 1986

<u>Country of Origin</u>	<u>Million US Dollars</u>	<u>Percent of Total</u>
Hong Kong	3,390	19%
Taiwan	2,633	15%
South Korea	2,573	15%
China	1,710	10%
Italy	850	5%
Philippines	474	3%
Japan	465	3%
Singapore	384	2%
India	345	2%
Mexico	321	2%

Table B. US Imports of Textile Fabrics and Yarns in 1986

<u>Country of Origin</u>	<u>Million US Dollars</u>	<u>Percent of Total</u>
Japan	856	16%
China	475	9%
Taiwan	445	8%
Italy	441	8%
South Korea	379	7%
West Germany	259	5%
Canada	241	4%
India	225	4%
United Kingdom	216	4%
Hong Kong	181	3%

Source: US Department of Commerce (imports valued F.A.S.).

Table C. US Imports of Clothing From China, 1980-86

<u>Year</u>	<u>Million US Dollars</u>	<u>Share of US Clothing Imports</u>
1980	250	4%
1981	422	5%
1982	635	8%
1983	773	8%
1984	863	7%
1985	967	6%
1986	1,710	10%

Source: US Department of Commerce (imports valued F.A.S.).